Internal Revenue Service

memorandum

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DPMadden

date: JUN 1 8 1986

to: District Counsel, Los Angeles W:LA

from: Director, Tax Litigation Division CC:TL

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subject: [redacted] Warrant Issue

This memorandum is in response to your written request for technical advice dated February 12, 1986. You have submitted a discussion paper for our consideration by transmittal dated April 7, 1986. This matter is in examination.

Issues

1. Whether the Taxpayer may claim as an ordinary deduction the loss incurred on the repurchase of its warrants, and whether the loss would be ordinary or capital. 0165.01-00; 1234.01-00.

2. How does the decision in Jim Walter Corporation v. United States, 498 F.2d 631 (5th Cir. 1974), affect the allowance of the deduction for the repurchase of the warrants? 0162.05-00.

3. Whether the Taxpayer can rely on Five Star Manufacturing Co. v. Commissioner, 355 F.2d 724 (5th Cir. 1966) to determine the tax character of the cost of repurchasing the warrants. 0162.02-00.

Conclusion

The Taxpayer may not claim a current ordinary deduction for the cost of repurchasing its warrants because the cost was capital in nature. Under the evidence presented, this matter comes within the holding of Jim Walter that the cost of repurchasing warrants which has its origin in a plan to change the corporate-capital structure of the Taxpayer is not currently deductible.

Even if the origin of the repurchase expenditure cannot be traced to the plan to change the corporate-capital structure of the Taxpayer, the Taxpayer may still not claim an ordinary deduction for the loss it incurred on the repurchase of its [redacted] warrants. At best, the Taxpayer could obtain a short term capital loss deduction. The loss incurred on the repurchase of the [redacted] warrants, however, would then qualify for ordinary loss treatment.

Five Star Manufacturing is not applicable to this matter because at the time of the repurchase the Taxpayer was not in dire or threatening financial condition. In any event, we do not agree with the decision in Five Star and limit its holding to that particular situation.

Facts

The Taxpayer is [redacted].

In the early [redacted]'s, it was believed that the Taxpayer's economic condition had deteriorated to such an extent that some restructuring was necessary to avoid financial embarrassment or collapse.

In [redacted], the Taxpayer, its lending banks, and the [redacted] agreed to a financial restructuring plan. The plan had three phases. Under Phase I, the banks agreed to a reduction in the interest rate charged to the Taxpayer on outstanding indebtedness and to an extension of a credit agreement. Under Phase II, the banks agreed to convert $[redacted] of the Taxpayer's debt into new $[redacted] preferred stock and other nonguaranteed debt into term notes. The preferred stock provided for annual sinking fund retirement from [redacted] through [redacted]. Lastly, under Phase III, the banks agreed to convert an additional $[redacted] of the Taxpayer's debt into new preferred stock if the Taxpayer succeeded in exchanging its outstanding convertible debentures for other new preferred stock. The Taxpayer also agreed to issue to the banks stock warrants in the Taxpayer's stock in connection with Phases I and II. The Taxpayer was under no obligation to repurchase the warrants.

Phase I occurred on execution of the agreement. On [redacted], the Taxpayer issued warrants to purchase [redacted] shares of its stock at a price of $[redacted] per share to the banks. The warrants were valued at $[redacted] each. They were to expire on [redacted].

Phases II and III were delayed. Phase II was completed in [redacted]. The Taxpayer issued [redacted] warrants to purchase stock at $[redacted] per share and an additional [redacted] warrants to purchase stock at $[redacted] per share to the banks on [redacted]. The banks demanded and received the additional warrants due to the delay in consummating Phase II. These warrants had a value at issuance of $[redacted] and $[redacted] per warrant respectively, and were to expire on [redacted].

As part of Phase III, the Taxpayer issued approximately [redacted] shares of convertible preferred in exchange for $[redacted] of its convertible subordinated debentures. This exchange offer ended in [redacted].

The parties agreed to defer the first stage of the redemption and retirement of the Phase II preferred stock scheduled under the sinking fund arrangement for [redacted]. That redemption took place in [redacted]; the second occurred as planned in [redacted].

In [redacted], the Taxpayer made a public offering of [redacted] shares of common stock at $[redacted] per share. In [redacted], all of the convertible preferred stock issued in connection with Phase III was converted or redeemed. As of [redacted], the following warrants remained outstanding and unexercised:

[redacted]	($[redacted] exercise price)	[redacted]
	($[redacted] exercise price)	

On [redacted], the Taxpayer entered into an agreement with the banks holding the warrants to repurchase the warrants on [redacted]. The obligation to repurchase was conditioned upon the successful public offering by the Taxpayer of additional common stock by [redacted]. The repurchase prices were to be based on the offering price of the additional common stock. On [redacted], the Taxpayer filed a registration statement with the S.E.C. The offering of [redacted] shares was made on [redacted], at a price of $[redacted] per share.

The Taxpayer announced a [redacted]-for-[redacted] stock split in [redacted].

On [redacted], the Taxpayer repurchased its outstanding stock warrants. The price paid for the [redacted] warrants was $[redacted] per warrant; the two groups of [redacted] warrants were repurchased for $[redacted] and [redacted], respectively. The Taxpayer computed a total loss on the repurchase of these warrants of $[redacted], of which $[redacted] was attributable to the [redacted] warrants. It deducted the entire amount as an ordinary loss for its taxable year ending [redacted].

The Revenue Agent believes that the repurchase of the warrants was motivated by the Taxpayer's desire to increase its equity position after being highly leveraged for a number of years.

You feel that the [redacted]-for-[redacted] split was the ultimate objective of the Taxpayer, but that the earlier transactions were necessary to achieve the capital structure for the Taxpayer desired by its management. The issuance of the stock and the stock split in [redacted] reduced the price per share of the Taxpayer's stock from over $[redacted] to the $[redacted]-$[redacted] range. You have considered the various transactions in [redacted] and [redacted], that is, the redemption or conversion of the convertible preferred, the issuance ~~of~~ over [redacted] additional shares of common, the repurchase of ~~the~~ warrants, and the stock split, as integrated steps in a strategy to achieve the final capital structure objectives.

You have requested technical advice on the issue of the propriety of the ordinary deduction claimed by the Taxpayer for the cost of repurchasing of the warrants. You perceive inconsistencies in Service position with regard to the treatment of costs of repurchasing warrants. You intend to fashion your advice to the Revenue Agent based on our advice.

Discussion - Issue I

I.R.C. § 165(a) allows as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. I.R.C. § 165(f) limits the deduction allowed to capital losses. In the case of a corporation, capital losses are allowed only to the extent of capital gains recognized during the taxable year. See, I.R.C. § 1211(a).

There is no dispute in this matter that the Taxpayer incurred a loss on the repurchase of its warrants.

I.R.C. § 1234(a), as did its predecessors, governs the character of gain or loss in the case of a holder of an option to buy or sell property. Generally, under its current form, gain or loss attributable to the sale or exchange of, or loss attributable to a failure to exercise, an option to buy or sell property is considered gain or loss from the sale or exchange of property which has the same character as the property to which the option relates has in the hands of the taxpayer.

Prior to [redacted], there was no Code provision regarding the tax consequences to the issuer of an option. Under general principles of tax law, money received under an option agreement was taxable income to the issuer in the year in which the option terminated by exercise or lapse when, for the first time, a satisfactory determination of its character could be made. See Virginia Iron Coal & Coke Co. v. Commissioner, 37 B.T.A. 195, 199 (1938), aff'd., 99 F.2d 919 (4th Cir. 1938), cert. den., 307 U.S. 630 (1938). If the option was exercised, the money received became a part of the amount realized on the transfer of the property. If the option lapsed, the money received was ordinary income to the issuer. See generally, Rev. Rul. 58-234, 1958-1 C.B. 279, 284.

Treas. Reg. § 1.1234-1(b) was added by T.D. 7152, 1972-1 C.B. 263, as support for ordinary income treatment to the issuer on the lapse of an option.

In Rev. Rul 72-198, 1972-1 C.B. 223, the Service held that a stock warrant issued by a corporation is an option under I.R.C. § 1234 as long as the warrant holder has the right to purchase the underlying stock. Furthermore, Rev. Rul. 72-198 held in part that upon a lapse of a corporation's outstanding warrants, the corporation recognizes ordinary income in an amount equal to the fair market value of the consideration it had received for the warrants. Rev. Rul. 77-40, 1977-1 C.B. 248, limited the effect of Rev. Rul. 72-198, but arguably only as to that latter holding, to warrants issued after the latter ruling's date of publication, April 24, 1972.

Service consideration of the tax effects of options increased with increased trading in options. It issued several private letter rulings regarding the consequences of the repurchase of warrants by the issuer. Relying on Rev. Rul. 72-198 that a warrant was an option for I.R.C. § 1234 purposes, the letter rulings reasoned:

> When an option is repurchased by the issuer, it is called a closing transaction. Although a closing transaction is treated by the holder of the option as a sale, it is not treated as a sale to the issuer; but rather, it is treated as a cancellation of the issuer's obligation to perform with any gain recognized treated as ordinary income.
>
> Conversely, any loss recognized by the issuer of an option in a closing transaction will be treated as an ordinary loss that is deductible in the taxable year in which the closing transaction becomes final.

Private Letter Rulings 7745009 (July 28, 1977) (citations omitted); <u>also</u>, 7952122 (September 27, 1979).

Congress perceived a potential for abuse in the disparate tax treatment to the issuers of options in stocks, securities, and commodities, which were exercised and produced capital gain or capital loss, and the tax treatment afforded to closing transactions with respect to those types of options which yielded ordinary gain or loss. In response, it codified the notion of the closing transaction and provided that any gain or loss to the issuer from a closing transaction as to those types of options mentioned above, be treated as a gain or loss from the sale or exchange of a capital asset held for not more than nine months (<u>i.e.</u>, as a short term capital loss for the period in question). <u>See</u> I.R.C. § 1234(b); Tax Reform Act of 1976, Pub. L. No. 94-455, § 2136(a). With respect to the types of options, mentioned above, this provision was made applicable only for those <u>granted</u> after September 1, 1976.

Treas. Reg. § 1.1234 was again amended in 1979 to reflect the 1976 law. T.D. 7652, 1979-2 C.B. 303. The purpose of the amendment was to follow up the established rule, that any gain to the issuer of an option arising from its lapse is ordinary income, with the following provision. "In addition, ~~any~~ gain or loss realized by the [issuer] as a result of a closing transaction, such as repurchasing the option from the holder, is considered ordinary income or loss. However, for the treatment of gain or loss from a closing transaction with respect to, or gain on the lapse of, an option granted in stock, securities, commodities, or commodity futures, see section 1234(b) and § 1.1234-3." See Treas. Reg. § 1.1234-1(b). Treas. Reg. § 1.1234-3 tracks the statutory scheme for those certain options granted after September 1, 1976. The earlier sentence, however, regarding the ordinary character of gain or loss on the repurchase of an option gives regulatory support for the holdings of Private Letter Rulings 7745009 and 7952122, discussed above. That is, assuming that a warrant is an option for the purposes of I.R.C. § 1234, then the repurchase of a warrant granted on or before September 1, 1976, would normally result in ordinary gain or loss to the issuer.

Following the above regulatory change, a renewed critical inquiry was initiated questioning the basic premise of Rev. Rul. 72-198 that stock warrants be treated as options for the purposes of I.R.C. § 1234. O.M. 19589, Reconsideration of Rev. Rul. 72-198 (May 20, 1982), recognized a basic distinction that the issuance of warrants is a transaction in the equity of the corporate issuer itself while an option is a transaction in the corporation's property. While the granting of an option could result in income, the quasi-equity nature of a warrant arguably should trigger I.R.C. §§ 311 and 1032 to preclude recognition of gain or loss on the exercise of a warrant. See also Handler, Will the Bull Market of the 1980s Lead to Answers for Warrants?, 37 THE TAX LAWYER 245 (1984). The Interpretative Division has agreed in theory with the decision of Jim Walter Corp. v. United States, 498 F.2d 631 (5th Cir. 1974), 1974-2 U.S.T.C. para. 9629, discussed below, that an issuer's transaction in its warrants are of a capital nature and should be treated under I.R.C. § 1032. O.M. 19589, supra.

In 1984, Congress amended I.R.C. § 1032 by adding that no gain or loss is recognized by a corporation with respect to any lapse or acquisition of an option to buy or sell its stock. See Tax Reform Act of 1984. Pub. L. No. 98-369, § 57(a). The amendment is effective for options acquired or lapsing after July 18, 1984 in taxable years ending after that date. Pub. L. No. 98-369, § 57(b) (emphasis supplied).

In summary, the treatment of a repurchase of warrants by the issuer and uncomplicated by collateral factors (see discussion of Jim Walter below) is as follows: as to warrants issued on or before September 1, 1976 and repurchased before July 18, 1984, gain or loss is considered ordinary income or loss; as to warrants issued after September 1, 1976 and repurchased on or before July 18, 1984, gain or loss is treated as a short term gain or loss from the sale or exchange of a capital asset; and as to warrants repurchased after July 18, 1984, no gain or loss is recognized.

Under the facts involving the Taxpayer in this matter, the tax consequences to the repurchaser of the warrants, absent collateral factors, is bifurcated. The warrants issued in [redacted] and repurchased in [redacted] would generate an ordinary loss of $[redacted]. The warrants issued in [redacted] and repurchased in [redacted] would yield capital loss of $[redacted].

We believe, however, that there are collateral factors involved in this matter which override the usual tax consequences resulting to the issuer from repurchasing its warrants. If the repurchase is part of an overall plan to change the corporate-capital structure of the Taxpayer, then the repurchase cost is capital in nature and may not be currently deducted.

It is well established that expenditures incident to the alteration of the corporate-capital structure are to be capitalized. See, McCrory Corp. v. United States, 651 F.2d 828 (2d Cir. 1981), 81-2 U.S.T.C. para. 9499; Mills Estate, Inc. v. Commissioner, 206 F.2d 244 (2d Cir. 1953), 53-2 U.S.T.C. para. 9525; Rev. Rul. 67-125, 1967-1 C.B. 31. Costs to change the corporate-capital structure contribute to the creation of an intangible long term asset for the benefit of future operations, and change the capital-equity structure of the corporation. McCrory, 651 F.2d 828, 833; Mills Estate, 206 F.2d 244, 246; cf., Woodward v. Commissioner, 397 U.S. 572 (1970), 70-1 U.S.T.C. para. 9348 (costs originating in the acquisition or disposition of a capital asset are nondeductible).

For example, a corporation's plan to convert its preferred stock into common is a plan to alter the capital structure. See, Skaggs Companies, Inc. v. Commissioner, 59 T.C. 201 (1972). Expenditures to insure that the conversion would take place are capital in nature since they arise out of the plan, and therefore are not currently deductible. Skaggs, 59 T.C. 201, 205-07; also, Rev. Rul. 60-254, 1960-2 C.B. 42.

In Rev. Rul. 67-125, 1967-1 C.B. 31, the Service considered the deductiblity of legal fees incurred for tax advice regarding: (1) a merger; (2) a stock split; and, (3) and I.R.C. § 302 redemption not qualifying as a partial liquidation. It reasoned that the legal fees were instrumental in determining a change in the corporation's capital structure. The ruling therefore concluded that the expenditures were incident to changes in the corporate-capital structure and are nondeductible.

The facts presented in this matter indicate a change in the corporate-capital structure of the Taxpayer similar to the transactions considered in the above mentioned case law and revenue ruling. The series of transactions in [redacted] and [redacted], the issuance of additional common stock, the repurchase of the warrants, and the stock split, each change the corporate-capital structure of the Taxpayer. The issue, then, is whether the repurchase expenditure was a part of the plan to alter the capital structure. If it was a part of that plan, then the expenditure may not be currently deducted. We have concluded that the expenditure was a part of the overall plan based on our interpretation of the principles laid down in Jim Walter, as discussed immediately below.

DISCUSSION - ISSUE II

You have inquired as to the effect of Jim Walter Corp. v. United States, 498 F.2d 631 (5th Cir. 1974), 74-2 U.S.T.C. para. 9629, on this matter. In Jim Walter, a corporation issued warrants in 1955. In 1957, it modified the rights under those warrants. In 1959, it repurchased them at a loss. The District Court found that the underwriters required the repurchase in connection with the 1959 public offering and therefore held that the payment for repurchase was a capital expenditure. Jim Walter Corp. v. United States, 73-2 U.S.T.C. para. 9682 (M.D. Fla. 1973).

The Court of Appeals for the Fifth Circuit affirmed. Jim Walter Corp. v. United States, 498 F.2d 631. It premised its conclusion on case law holding that expenditures incurred in connection with a recapitalization, and in particular with an issuance of stock, are nondeductible capital expenditures. The Court relied on alternative grounds to support its holding that the cost of repurchasing the warrants was a capital expenditure. First, the repurchase was a cost of the recapitalization and thus had its origin in the corporation's issuance of stocks and bonds. Second, the repurchase of the warrants resulted in an alteration of the corporation's capital structure by having extinguished the corporation's obligation to issue its stock.

For litigation purposes, this Office has decided to employ only the first basis of Jim Walter in cases in which the origin of the repurchase expense is to facilitate a change in corporate capital structure, as through a recapitalization by the issuance of new stock. See O.M. 19552, Progressive Corporation (February 23, 1982). The Court's second basis for its decision, which was based on contruing the repurchase of the warrants as an extinguishment of the corporation's obligation to issue its stock, wasviewed as inconsistent with the Service's position in Rev. Rul. 72-198, 1972-1 C.B. 223 that the lapse of a warrant generates ordinary income to the issuer under I.R.C. § 1234. The Interpretative Division has thus concluded that the Government should not argue the second rationale unless and until Rev. Rul. 72-198 is revoked. See O.M. 19552, p. 2. 1/ (The Service has announced that Rev. Rul. 72-198 is obsolete with respect to stock warrants that were acquired after July 18, 1984 in taxable years ending after that date. Rev. Rul. 86-9, 1986-4 I.R.B. 5.)

Jim Walter, therefore, may be used as support for the argument that a repurchase expenditure having its origin in a plan to change the corporate-capital structure is capital in nature and therefore should not be currently deducted.

The Corporate Tax Division agrees with the Jim Walter origin of the claim analysis. Specifically, although the warrants in Jim Walter were issued on incorporation in 1955 and were modified in 1957, the origin and character for the repurchase was found to be the need to eliminate the warrants in order to carry out a new public offering in 1959. Thus, in determining the origin and character of a repurchase, the proper focus is on the events that cause the repurchase and not on the original issuance of the warrants. See, e.g., Private Letter Rulings 8023025 (February 28, 1980) and 8252012 (March 16, 1982). 2/

There have been statements made in several private Letter rulings that Jim Walter only applies to warrants issued prior to September 2, 1976 (see, e.g., Private Letter Ruling 8334002 (April 29, 1983)). This position was not essential to the holdings of those memoranda and is no longer the position of the Corporate Tax Division. The theory behind Jim Walter, that some otherwise deductible expenses are nondeductible because they represent capital expenditures, is a theory that overrides the general Code provisions concerning deductions. Furthermore, the origin of the claim analysis requires inquiry into the repurchase of the warrants and is not necessarily shaped by the facts of their issuance.

As indicated above, the facts presented in this matter indicate a change in the corporate capital structure of the Taxpayer. The series of transactions in [redacted] and [redacted], the issuance of additional common, the repurchase of the warrants, and the stock split, each changed the corporate capital structure of the Taxpayer.

Furthermore, the repurchase of the warrants has some nexus to a change in the corporate-capital structure which would support a conclusion that the repurchase arose out of the overall plan. You have noted that the repurchase was conditioned on the success of the public offering in [redacted]. This condition was part of the [redacted], agreement between the Taxpayer and the warrant holders. We believe that it is likely the Taxpayer described this use of proceeds in its registration statement filed with the S.E.C. in connection with the offering. Such public disclosure would imply the materiality of the condition to the offering and permit the nexus noted by Jim Walter to be drawn. Cf. Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977) (securities law case under Rule 10b-5, the Court adopts the standard of the Supreme Court in a related context that an omitted fact is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding whether to invest). We believe that this nexus is prima facie evidence that the origin of the repurchase expenditure was in connection with the issuance of additional stock in [redacted]. We therefore conclude that the matter is controlled by Jim Walter, so that the repurchase costs at issue are is not currently deductible.

Evidence which would supplement this prima facie evidence that the repurchase was in connection with the public offering might be found in any correspondence between the Taxpayer and its underwriter for the [redacted] issue. This would further establish the tie between the two. The Court in Jim Walter relied on the agreement between the corporation and its underwriter as the basis for its conclusion that the origin of the obligation originated in a change of the corporate-capital structure.

You may wish to seek further evidence to support the arguement that the repurchase of the warrants originated in an overall plan to change the corporate-capital structure of the Taxpayer. In that regard a desire to switch from debt to equity may be provable. Should further examination establish a purposeful scheme on the part of the Taxpayer to act in a way to change over its corporate-capital structure from debt to equity, with the repurchase aiding in that change, then the general notions of Jim Walter would require the disallowance of any deduction of the repurchase loss.

You have indicated that the series of transactions in [redacted] and [redacted] may have been integrated steps toward a goal of pushing down the price per share of the Taxpayer's common stock and that this would have enabled the Taxpayer to convert its highly leveraged debt position to equity. We believe, however, that there will be substantial difficulty in demonstrating that the origin of the repurchase was the desire to drive down the market price for the stock. Since the value of the warrants rose with the increase in stock price, the likelihood increased that the warrants would be exercised. The greater the probability the warrants would be exercised, the more the outstanding warrants themselves would tend to depress the market price of the stock, because of the potential for dilution of stock ownership. Obversely, repurchasing the warrants would eliminate the potential for dilution and remove the drag on the market price. Thus, repurchasing the warrants would have an upward effect on the market price and would thus be inconsistent with the suspected desire to drive that price down.

DISCUSSION - ISSUE III

You have also requested our views on the applicability of Five Star Manufacturing Co. to the facts of this matter. In Five Star Manufacturing Co. v. Commissioner, 40 T.C. 379 (1963), the petitioner corporation had been experiencing significant business problems. It had lost its patent license agreement on which it conducted operations. The patent holder was willing to enter into a new agreement with only one of the shareholders of the corporation, and was unwilling to enter into any agreement which would involve the other shareholder. The corporation thereafter purchased the fifty percent interest of the latter shareholder at a foreclosure by public auction. It credited the value of the shares against an outstanding judgment it held against the shareholder. The corporation then regained the patent license and continued in business.

The corporation deducted the amount paid for the shares at auction, and argued that the amount was an ordinary and necessary business expense under I.R.C. § 162 or a bad debt under I.R.C. § 166. The Service disallowed that deduction. The parties agreed that I.R.C. § 311 did not apply to the case. See, Five Star Mfg., 40 T.C. 379, 387; O.M. 15262, Five Star Mfg. (March 25, 1966).

The Tax Court upheld the Service. It found the stock had value which precluded bad debt treatment. Futhermore, the cost of the stock provided a benefit which extended beyond that taxable year. This made the taking of a current deduction inappropriate. The Court stated:

> Thus, even if it be assumed that the basic purpose of the acquisition of the stock was to benefit the petitioner's business by making it possible to regain the right to manufacture and sell the automobile heaters, the purchase price would not be a deductible current expense. Rather, it seems obvious that any benefit resulting from the purchase of the stock would extend over an indefinite number of years.

Five Star Mfg., 40 T.C. 379, 391.

The Court of Appeals for the Fifth Circuit reversed the Tax Court. Five Star Mfg. v. Commissioner, 355 F.2d 724 (5th Cir. 1966), 66-1 U.S.T.C. para. 9191. The Court held that the corporation was entitled to an I.R.C. § 162 expense of the amount paid for the shares. It found that the payment was necessary to terminate the shareholder's interest in the corporation which facilitated the regaining of the patent license. The payment was also ordinary because it permitted the corporation to use its assets for income production by freeing its management from unwarranted fetters. Five Star Mfg., 355 F.2d 724, 727.

No certiorari was requested because the effect of I.R.C. § 311 was not argued. I.R.C. § 311 provides in relevant part that a corporation recognizes no gain or loss on a distribution of property with respect to its stock. Section 311 is limited to distributions which are made by reason of the corporation-stockholder relationship; it does not apply to transactions between a corporation and a shareholder in his capacity as debtor, creditor, employee, or vendee, where the fact that the debtor, creditor, employee, or vendee is a shareholder is incidental to the transaction. Treas. Reg. § 1.311-1(e)(1). In Five Star Mfg., one of the primary motives for the purchase was to terminate the shareholder's interest. The status as shareholder was not incidental to the transaction, and the exception of Treas. Reg. § 1.311-1(e) would not apply. Section 311 should have precluded recognition of any loss on the distribution of money with respect to its stock. See, O.M. 15262, Five Star Mfg. 3/ Later cases have limited Five Star Mfg. to its particular facts, and have stated that amounts paid to purchase stock may be deductible only if the purchase is necessary to the survival of the corporation. See, e.g., H. & G.Industries, Inc. v. Commissioner, 495 F.2d 652, 657 (3rd Cir. 1974), 74-1 U.S.T.C. para. 9396; Jim Walter Corp. v. United States, 498 F.2d 631, 638-39 (5th Cir. 1974), 74-2 U.S.T.C. para. 9629; Markham & Brown, Inc. v. United States, 648 F.2d 1043, 1045 (5th Cir. 1981), 81-2 U.S.T.C. para. 9518.

The Revenue Agent has stated that the Taxpayer relied upon Five Star Mfg. for an earlier audited period as support for deducting the costs of issuing the warrant since those expenditures were made to save the Taxpayer from dire and threatening consequences. He has inquired whether the same rule is possibly available on the repurchase of the warrants. He notes that the Taxpayer was in improved financial health at the time of the repurchase and would not have incurred the $[redacted] expense of repurchase had it not chosen to do so.

We agree with the Agent. At the time of the repurchase of the warrants, the Taxpayer was indeed in a better financial position than at the time of issuing the warrants. Five Star Mfg. is inapposite. For the instant case, there is no evidence of any dire and threatening consequences impelling the repurchase of the warrants.

Finally, even if the origin of the repurchase cannot be traced to a capital transaction, the ordinary deduction claimed by the Taxpayer in connection with the loss on repurchase was improper in part. Under I.R.C. §1234, the Taxpayer could claim an ordinary deduction on the repurchase of the [redacted] warrants but could only claim a short term capital loss on the repurchase of the [redacted] warrants.

We believe that the cost of repurchasing the warrants traces its origin to an issuance of additional common stock in [redacted] and possibly to a general plan to change the corporate-capital structure of the Taxpayer. Under the reasoning of Jim Walter the Taxpayer should not be allowed any current deduction for the cost of repurchasing the warrants, since the expense was capital in nature.

Since the evidence supports a conclusion that the Taxpayer was not in financially threatening condition in the year the warrants were repurchased, Five Star Manufacturing should not apply. Moreover, the Service disagrees with the result reached in Five Star.

ROBERT P. RUWE

By: Alfred C Bishop Jr

ALFRED C. BISHOP JR.
Chief, Branch No. 2
Tax Litigation Division

ENDNOTES

1. We therefore caution that Private Letter Ruling 8013018 (December 28, 1979) does not reflect current litigating position since it applies Jim Walter to a warrant repurchase which served no other purpose than to extinguished the corporation's obligation to issue additional stock.

2. We recognize some imprecise language in the private letter rulings from the Corporate Tax Division regarding the determination of the origin of the repurchase expenses. For example, in Private Letter Ruling 8220001 (December 30, 1981), the facts show that the taxpayer sought to repurchase warrants from its lenders. Repurchase of the warrants would relieve the taxpayer of the obligation to perform certain registration covenants with respect to the common stock to be acquired upon exercise. The private ruling reasons that

> [i]n the instant case, the repurchase was undertaken by the taxpayer in connection with the issuance of new securities. The only indication as to why the taxpayer repurchased its warrants was the fact that it was relieving itself of an obligation under the loan agreement .... Unlike Jim Walter the taxpayer did not want to increase its capitalization and had no power without the holder's consent to repurchase the warrant. [emphasis supplied]

That the repurchase was undertaken in connection with the issuance of new securities is unsupported by the facts. If the connection were true, Jim Walter could not be so readily distinguished. Rather, the facts do support a relief from registration obligations inherent in the warrants themselves. The letter ruling does, however, focus on the origin of the repurchase rather than the reason for the issuance of the warrants themselves.

There may be a similar blurring of the test for the origin of the repurchase in Private Letter Ruling 8044009 (July 24, 1980). The Corporate Tax Division now believes that these letters are erroneous insofar as they suggest that the origin of a repurchase of warrants must trace back to the issuance of the warrants. Rather, the origin of the expense depends upon the facts and circumstances surrounding the repurchase.

3. There is no serious argument that I.R.C. § 311 could apply in the case of this Taxpayer's repurchase. For that Code section to apply, the repurchase would have to be with respect to "stock". "Stock" cannot be construed to include warrants. Moreover, in that same section, there is a distinction drawn between stock and rights to acquire stock for the purposes of describing the relevant distribution. See I.R.C. § 311(a)(1). See also, O.M. 19589, Reconsideration of Rev. Rul. 72-198, (May 20, 1982) (recommending an amendment of the regulations to both I.R.C. §§ 1032 and 311 to bring stock warrants within their scopes).